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Statement of

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Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

August 16, 1962.

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Mr. Chairman:

It may be that just about everything that can be said about matters of interest to the Members of this Committee has already been said by other witnesses, but I should like nevertheless to be as helpful as possible in discussing economic and credit conditions today.

Much in the recent flow of statistical information has indicated a definite loss of momentum in the pace of economic expansion. This was particularly true of the June reports. In that month, there were declines in durable goods orders, average hours of work at factories, retail sales and housing starts, and only small gains in industrial production, employment and personal income. Altogether, the impression of slowdown seemed well confirmed.

There has been a popular tendency to view the various signs of slowdown as foreshadowing an imminent upper turning point in the economic cycle. Judged from the perspective of cyclical indicators, which in the past have shown a tendency to run ahead of the over-all data, this view has perhaps been reasonable.

I sometimes wonder though if we have not become overly sensitive to cyclical indicators -- we read, watch, study, and talk about them so much that we may have become like medical students who acquire each disease as they read about its symptoms in their textbooks. We ought

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to remember that, while leading indicators have correctly foretold some recessions, they have also on occasions given portents of recession that did not occur.

In June, our economic data were subject to certain special influences and, if allowance is made for these, the situation does not appear so persuasively discouraging as appeared at first sight. Thus, using up the inventory accumulated in anticipation of a steel strike that did not occur affected not only new orders for steel but also employment and hours of work in the steel industry, and unemployment claims in steel centers.

The steel industry is so large that declines in that one industry can at times result in declines in over-all manufacturing orders, employment, hours of work, and many other measures of economic activity. Observers who simply count the pluses and minuses among the cyclical indicators run the risk of being overly influenced by the reflections of a decline in one industry, not of cyclical origin, showing up several times in their lists of unfavorable omens. In addition to the steel situation, though of less importance, a strike at some auto plants affected production and sales in June. The adverse effect of this on the June data should not be interpreted as being of cyclical significance.

Nevertheless, the June showing as a whole was not strong. And it certainly made clear that the economy was moving ahead more slowly than

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the optimistic goals widely discussed at the turn of the year.

From data now available for July, the economic situation appears improved. The unemployment rate was down slightly, non-agricultural employment rose somewhat further, and labor market data were definitely encouraging in another respect: they showed a fairly large decline in the number of long-time unemployed.

Among other information on July, retail sales rose briskly, with new domestic auto sales and department store sales both making a strong showing. Private construction activity, seasonally adjusted, held its advanced level. The Board's index of industrial production, which was released early this week, gained almost a full point, advancing to a new record high approximately one-fifth above the 1957 level.

Preliminary indications from production schedules and weekly sales reports suggest that the general improvement of the economy carried forward in early August.

The information on consumers' purchase plans obtained in July by the survey conducted for the Board each quarter by the Census Bureau gave two important indications. First, consumer buying plans had not been adversely affected over-all by the recent stock market decline and the mixed economic tendencies shown for June. Second, as you may recall from earlier testimony by a member of our staff, the data show some strengthening of consumer purchase plans since early this year, especially for household durable goods.

Consumers are in a good financial position. Their incomes rose further in July to a new record high, and so did their savings. The payments on

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debt that consumers are obligated to make each month have risen less rapidly than their incomes. Furthermore, defaults on instalment credit have declined sharply over the past 18 months to levels at or close to the lows for recent years.

Business concerns' retained earnings and depreciation allowances in recent months have also been large, in many instances considerably in excess of current needs for replacement and expansion. This form of saving has been used in providing an additional flow of funds into credit markets and into extensions of trade credit as well. Meanwhile, business demand for bank loans has been less vigorous than in this stage of previous upswings. Banks, therefore, have sought other outlets for their funds and have increased other loans and investments, especially their holdings of State and local securities and real estate loans. Demand deposits have changed little so far this year, while time and savings deposits grew very rapidly in the first quarter and then continued to expand substantially but at a lesser rate.

Over the first half of the year, short-term interest rates fluctuated within a narrow range around a 2-3/4 per cent level. Since late June, the level has been a little higher, with the range on 3-month Treasury bills running between 2.80 and 3 per cent. Yields on longer term U. S. Government, State and local government, and corporate issues meanwhile declined through midspring and subsequently moved moderately upward, but they remain below the earlier highs for the year. Throughout the

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year, mortgage yields have moved downward.

The decline that has taken place in long-term interest rates has reflected in large part the increased availability of funds in long-term sectors of the market, as the rapid increase in time and savings deposits at commercial banks was accompanied by continued large inflows of funds to mutual savings banks and savings and loan associations. Demand for long-term funds in recent months has been generally moderate.

My comments would be incomplete if I neglected to mention the persistent problem of restoring balance in our international accounts. The problem of domestic expansion is interrelated with our international problems and all of them must be thought about at the same time.

The United States has been making progress in reducing its over-all deficit in international transactions. The deficit came down from nearly $4 billion in 1960 to about $2-1/2 billion last year, and to an annual rate of just under $1-1/2 billion in the first half of 1962. Even so, we have no grounds for complacency. We must move further towards international balance next year, and we must also achieve and maintain equilibrium in the accounts in future years.

U. S. foreign trade has developed in an encouraging way this year. Total exports have been rising, with exports to Western European countries especially strong. While imports also have risen, they have not spurted ahead as they did in the preceding period of cyclical expansion and so have

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remained lower in relation to the gross national product. Both our export and our import performances would indicate that we have been competing effectively in international trade, and international price trends support this interpretation. The level of wholesale prices has been stable in this country for some time, while prices in industrial countries abroad have risen.

The merchandise trade surplus, at an annual rate of $5 billion in the first half of 1962, is large but not large enough to match our large net payments for aid, for military expenditures, and for net private U. S. lending and investment abroad. And it would probably be unrealistic to expect the whole of the remaining adjustment to come through yet further expansion of the trade surplus. That is why the Government has been working, both from the procurement side and through negotiations with our allies abroad, to reduce the balance-of-payments burden of our foreign aid and military programs. That is why we have had to pay close attention to the possible effects that monetary and credit policies may have on international movements of capital.

Taken together, domestic economic and balance-of-payments developments have posed a problem for monetary policy, but in my judgment that problem has not yet constituted as clear cut a dilemma as some observers suggest. While it has been necessary to formulate policy in the light both of the credit needs of the domestic economy and the potential effects on

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international capital movements, up to the present time it has not been a matter of choosing between domestic and international goals.

With the rare exception of an internal liquidity crisis, such as that experienced in the early 1930's, it is never helpful to sound recovery or economic expansion to flood credit markets with redundant funds. When resources are not fully employed, credit should be readily available to meet the legitimate needs of commerce, industry and agriculture -- as it is now -- but no constructive purpose is served by expanding the credit stream to the point where it overflows its banks. So far, we have been able to pursue policies which have not interfered with the ready availability of credit in the domestic markets at rates generally about even with those prevailing in early 1961, and in some critical areas substantially lower.

Fortunately, we have been free from inflation and the expectation of imminent inflation. This has made possible a more liberal policy with respect to reserve availability, a greater growth in bank credit, and less upward movement of interest rates than in any other recovery and expansion in recent history. In the last 12 months alone, we have added almost a billion dollars to bank reserves, bank credit has expanded by $17 billion, and high-grade long-term corporate bonds and State and municipal securities are about 1/4 of 1 percentage point below their year-ago levels.

At the same time, we have generally maintained short-term rate relationships with other major financial markets such as to avoid encouraging outflows of short-term funds. The fact that we have done and are continuing

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to do this, as we strive to improve our basic balance-of-payments situation, is bound to strengthen confidence in the dollar at home and abroad. In my judgment, this enhanced confidence is essential if we are to solve our balance-of-payments problem and promote domestic prosperity.

This leads me to the matter of deficit financing. It now seems most likely that we shall experience some deficit in our budget for fiscal 1963. That deficit would, of course, be increased if taxes are reduced during the current fiscal year.

I have stated quite explicitly my belief that such deficits as we may experience, whether they are due to a shortfall of receipts under the existing tax structure, an increase in expenditures, or a reduction in tax rates, should be met by borrowing from the real savings of businesses and individuals, not through the creation of money through the banking system.

This does not mean that we will experience less easy conditions in credit markets. What happens will depend on many things -- most importantly on the rate of activity in the economy: credit conditions may be tighter, or easier, or the same.

It is also helpful to recognize that in the American banking system there is an important distinction between total bank credit <u>expansion</u> and that portion of it which can be traced to the <u>creation</u> of money and credit. The loans and investments of commercial banks in the United States can grow in two ways: one, through people placing more savings in banks in

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the form of time and savings deposits; or two, through the creation of demand deposits. Hence, bank credit can expand substantially without any significant money creation, as it has done in some periods. Alternatively, growth in bank assets can be -- as at times it has been -- associated almost entirely with money creation.

Analysis of these processes would be simpler if we had an institutional structure in this country in which the money creation function was entirely separate from what is called the savings intermediary function -- the collection of small savings and their investment for the benefit of depositors, of shareholders and of policyholders -- but that is not the case. To the extent that individuals place their savings with banks and that banks, in turn, invest these savings in Government securities, the deficit which led to the issuance of the securities is being financed by real savings just as surely as if the individuals had purchased savings bonds in the first instance.

Moreover, a certain amount of money creation to meet the legitimate needs of a growing economy is a necessary and normal function of the banking system, and it is expected reserves will be provided for expansion to meet such needs. Some part of the normal growth in banks' assets which accompanies this money supply expansion must, as a simple matter of banking prudence, take the form of additions to the secondary reserves of the banking system, which consist largely of Government securities. Additions to banks' holdings of Government securities due to additional

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flows of savings through this particular intermediary or to normal growth in the money supply do not represent the financing of Government deficits with bank-created or "printing press" money. Such additions are not inflationary and do not pose any threat to the soundness of the dollar.

What would be damaging to the strength of the dollar would be the deliberate expansion of the credit base, above and beyond the needs of the economy, in order to provide a ready market for the Government's borrowing. This was done in the United States during World War II, and in other countries both at that time and during the economic chaos that followed. It is still being done in some unfortunate countries today. The results have invariably been bad, and have ranged from damaging, as they were here, to nearly disastrous, as they have been in some other countries. The process of withdrawal and correction is always painful and difficult.

The only sure safeguard against the financing of deficits through bank credit creation lies in careful control over the process by which bank credit and money are created. As I have said, the Federal Reserve is determined to provide, on the one hand, the reserves needed to support the necessary and healthy expansion of bank credit and money required to meet the needs of a growing economy, and on the other, not to again become entangled in the vicious circle of financing Government deficits with bank credit created solely for that purpose.

In closing, let me summarize as specifically as I can my view with respect to the economic situation today.

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All in all, the performance of the economy has been disappointing in that it thus far has failed to reach the goals set for it by some and predicted for it by others. Yet the economy has withstood some rather severe shocks -- last fall an auto strike, this year a major steel inventory adjustment and the sharpest stock market break since the 1930's -- and still it has moved forward. On the one side, it has not achieved the levels of manpower or physical resource utilization we would all like to see; on the other, the latest data do not, in our judgment, confirm that we have reached or passed a turning point in the cycle at this time. The most likely possibility in the period immediately ahead seems to be for a continuation of mixed movements in the more sensitive indicators and some further growth in the broad aggregate measures of economic activities.

Now a final word, about monetary policy and credit conditions. The one factor over which the Federal Reserve has anything like complete control is the volume of reserves available to the banking system. In my judgment we have supplied -- and are now supplying -- all the reserves the banking system requires to meet the American economy's needs for credit today and to foster its further economic progress.

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